# U. TREAS. REG. SECTION 1.337(d)-4 AND EXEMPT ORGANIZATIONS

**by**
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## 1. Introduction

This article discusses provisions of corporate law that may apply to transactions of large exempt organizations or related entities, especially hospitals. The purpose for discussing these provisions is to enable EO specialists to analyze cases and identify potential issues affecting the exempt organization or requiring referral to or coordination with Examination Division.

## 2. Background

An exempt organization that purchases a for-profit corporation may excessively benefit the sellers if it pays more than fair market value. Analyzing a transaction to determine if an exempt organization overpaid can be difficult, especially if the transaction is complex. For example, a professional medical corporation may be made up of various corporate entities and partnerships. The medical practice may be a partnership because of favorable tax considerations, but a corporation will own its assets. The corporation's stockholders usually are limited to the physicians who operate the medical practice or a physician-controlled partnership.

### A. Tax Considerations for Corporations

A for-profit medical group operating a medical practice, MRI, or ambulatory surgery center, or holding real estate, fixtures, and medical equipment through a "C" corporation (or under certain circumstances an "S" corporation) is subject to double taxation (once at the corporate level and once at the shareholder level) on the earnings and appreciation while the investment or business is in “corporate solution”.[1]

When an IRC 501(c)(3) hospital or controlled entity within the tax-exempt system acquires a physician practice or related assets, it usually operates the business or assets on a tax-exempt basis. If the hospital acquired all the assets of a physician practice from the

[1] An S corporation is generally treated for income tax purposes as a pass-through entity, the income and deductions of which flow through and are taxed at the shareholder level. The corporation pays no corporate level tax and the shareholders pay the tax on the corporate operations roughly in place of the shareholder level tax on distributions, which leaves the shareholders larger after-tax proceeds from corporate profits distributed to the shareholders. However, under IRC 1374, if a C corporation files after 1986 to elect S status, the net unrealized built-in gain in its assets at the time of conversion to S status is subject to a special corporate level tax on any net built-in gains recognized during its first 10 years as an S corporation.

physicians' C corporation, the C corporation would be taxed under IRC 1001 on any gain from the sale of those assets. Only the after-tax proceeds would be available for distribution to the physician/shareholders, who would also pay individual tax (generally under IRC 331 or 301, depending on whether the corporation liquidates). Thus, in this example the physician/shareholders' proceeds are reduced twice.

The results are similar if the C corporation first distributes the practice or assets to the shareholders, who then sell them to the hospital. The C corporation still recognizes gain on the distribution of assets under IRC 311 or 336 (depending on whether it liquidates) as if sold for fair market value and, the shareholders are taxed on the distribution, generally under IRC 301 or 331.

If instead the hospital purchased the stock of the C corporation, the physician-shareholders still bear the individual level of tax on their gain, but the corporate level of tax on the C corporation would remain deferred. In this situation, the physician-shareholders' proceeds would be greater because only the individual level of tax would reduce the profits, as corporate tax is deferred. However, the hospital would be operating the C corporation as a for-profit subsidiary, which would not make effective use of the hospital's tax exemption. Therefore, to operate the corporate assets as an IRC 501(c)(3) function, the hospital would need to have the assets distributed to it. That distribution generally triggers the corporate level tax (which had been deferred), either under IRC 311 (if the corporation is not liquidated) or under section 337(b)(2) (if the corporation is liquidated).

B. Adverse Effect on Charity

Both methods described above for the hospital to obtain the C corporation's assets result in two levels of taxation. They differ, however, in who is responsible for the tax. If the hospital purchases the C corporation's stock, the corporate level tax is borne while the corporation is owned by the exempt hospital, and does not reduce the proceeds available to the selling physician-shareholders. However, in an arm's-length purchase, the buyer would pay less for the stock than it would for the net assets because the buyer assumes the burden of the corporate level tax on the assets built-in appreciation. Thus, the hospital's failure to make a downward adjustment to the fair market value of the stock, as determined by an independent appraisal, to reflect the corporate level tax might be viewed as a private benefit to the selling physicians.

IRC 337(b)(2) provides an exception to the above example. The purchasing exempt organization is not subject to corporate tax if, immediately after the distribution, it uses the property in an unrelated trade or business. However, this exception is usually moot because a hospital will use the corporate assets in an exempt function.

(1) An Example of Application of the Law

In 1990, 10 physicians invested $50,000 each ($500,000 in total) in a C corporation to purchase land and construct a freestanding ambulatory surgery center. The ambulatory surgery center was constructed and has thrived. In 1999, the physician-owners decided sell the center to a local hospital. The hospital wanted to purchase the corporate assets instead of the stock because of liability concerns and to operate as a tax-exempt organization. Assume for this example that the C corporation's basis in its assets is $1 million and it has no liabilities. If it sells its assets to the hospital for $6 million, it will be taxed on its gain (35% x $5 million = $1.75 million), leaving $4.25 million for the physician/shareholders in liquidation. They will net about $2.57 million on the sale after paying individual tax (39.6% x $4.25 million = $1.68 million).

In contrast, if the hospital buys the C corporation stock from the physicians, the physicians will be taxed $1.68 million on their gain on the stock, but the corporate tax, $1.75 million, will be deferred. The $1.75 million tax on the built-in gain will be borne by the C corporation over time through operations or at the time it either liquidates and distributes all its assets to the hospital, or converts to a tax-exempt subsidiary. As the corporate tax will reduce the hospital's return on its investment, it should, in an arm's-length transaction, be reflected in the amount paid to buy the stock. Failure to factor the corporate tax would provide a substantial benefit to the physician/shareholders.

C. Examination

During an examination, the EO specialist should review any documentation of an exempt organization's purchase of the stock of a for-profit corporation. In particular, the specialist should determine if the exempt organization adjusted the fair market value, as determined by an independent appraisal, to reflect the corporate tax. Exempt Organizations Division may need to request assistance from Examination Division in reviewing appraisals of the taxable corporation, negotiation documents, board and committee reports, and sales documents to determine if the purchase price was at fair market value, including a discount for the corporate tax liability.

3. Background of Reg. 1.337(d)-4

Reg. 1.337(d)-4 implements part of repeal of the *General Utilities* doctrine in the Tax Reform Act of 1986. Under the *General Utilities* doctrine, which took its name from *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), corporations were not required to recognize gain or loss when they distributed appreciated or depreciated property to their shareholders. The *General Utilities* doctrine applied to distributions of property in complete liquidation, certain sales of property in connection with a complete liquidation, and nonliquidating distributions of property. It was codified in former sections 311, 336, and 337 of the Internal Revenue Code of 1954.

The *General Utilities* doctrine was an exception to the general rule that corporate income is taxed twice, once to the corporation when it is earned and again to the corporation's shareholders when the earnings are distributed. The *General Utilities* doctrine allowed corporations to avoid corporate-level tax on the disposition of appreciated assets because the transferee received a fair market value basis in the assets but the corporation did not recognize any gain.

Congress began restricting the *General Utilities* doctrine in 1969 with a series of amendments, and repealed it, with limited exceptions, in the Tax Reform Act of 1986. The 1986 Act amended sections 336 and 337 to generally require corporations to recognize gain or loss when appreciated or depreciated property is distributed in complete liquidation or sold in connection with a complete liquidation.

IRC 337(a) provides one of the limited exceptions to *General Utilities* repeal by allowing a subsidiary to liquidate into a corporation owning 80-percent of its stock (as defined in IRC 332(b)) without recognizing gain or loss. The 80-percent distributee takes a carryover basis in the distributed property. However, under IRC 337(b)(2), this nonrecognition exception generally does not apply is the 80-percent distributee is a tax-exempt entity.

The Tax Reform Act of 1986 added IRC 337(d), which authorized regulations to insure that *General Utilities* repeal shall not be circumvented through use of a tax-exempt entity. This includes rules to require recognition of gain if a C corporation transfers appreciated property to a tax-exempt entity in a carryover basis transaction that would otherwise eliminate corporate level tax on the built-in appreciation.

Reg. 1.337(d)-4 became effective on January 28, 1999. Under reg. 1.337(d)-4, a taxable corporation that transfers all or substantially all its assets to one or more tax-exempt entities, or that becomes a tax-exempt entity, must recognize gain or loss as if the assets were sold at their fair market values. Reg. 1.337(d)-4 applies to asset transfers after January 28, 1999, unless the transfers are under a written agreement that is binding on or before that date.

## A. Effect of Pre Reg. 1.337(d)-4 Transactions on Exempt Organizations

Before January 28, 1999, a taxable corporation could change its status from taxable to tax-exempt without recognizing gain or loss on its assets. If an exempt organization purchased all the stock of a taxable corporation and later liquidated it, the sellers would have recognized gain or loss on their stock, and the taxable corporation would have recognized gain or loss on the assets when it was liquidated. In contrast, if the exempt organization did not liquidate its newly acquired subsidiary, but through article amendments and other changes converted it to a tax-exempt subsidiary, no recognition of gain or loss would have been required, and no corporate level tax would have been imposed. Thus, the C corporation's assets could have left "corporate solution" without corporate level tax on the built-in appreciation.

If a taxable corporation purchased the C corporation's stock, it could liquidate the acquired corporation without immediately recognizing gain or loss, but it would take the assets at their carry-over bases. One result of this disparate treatment was that the stock of a taxable corporation with appreciated assets could be worth more if was purchased by an exempt organization because the appraisal would not need to consider corporate tax on liquidation. Accordingly, a taxable corporation's shareholders may have received more from selling their stock to an exempt organization than they would have received if they had sold all the stock to a taxable entity. This was not considered excessive private benefit to the sellers, though, because the exempt organization did not pay in excess of fair market value.[2]

Therefore, an EO examiner may see situations that look abusive but that were, in fact, allowed under prior law. The following examples illustrate allowable pre-Reg. 337(d)-4 transactions.

(1) Hospital A or medical foundation B acquires the stock of medical practice C, a taxable professional corporation. Medical practice C merges with a tax-exempt affiliate of hospital A or with medical foundation B, created by A to operate C. This is an "A" reorganization with no gain recognition to C, and no corporate tax.

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[2]Generally a taxable corporation, if making the same purchase, would discount the purchase price below fair market value to take into account the tax liability it could incur under certain circumstances. Therefore, generally, an exempt purchaser could afford to pay more for the same property than a taxable purchaser does.

(2) In the 1980's, hospital A formed a taxable subsidiary D, an out-patient clinic, to conduct activities that would have generated unrelated business income if A conducted them directly. D’s activities evolved so that by the early 1990’s it engaged exclusively in activities related to IRC 501(c)(3) purposes. In 1994 D amended its articles of incorporation to meet IRC 501(c)(3) requirements, exchanged its stock interest for a membership interest by reincorporating in another state to change from a stock to membership corporation, and successfully applied for recognition of exemption under IRC 501(c)(3). These changes did not require D to recognize gain on its assets and did not subject D to corporate tax.

4. Effect of Reg. 1.337(d)-4

Reg. 1.337(d)-4 eliminates the circumvention of corporate taxes described above. The final regulations generally apply to a taxable corporation that transfers all or substantially all its assets to a tax exempt organization, or converts from a taxable corporation to a tax-exempt corporation in a transaction other than a liquidation, and generally requires recognition of gain or loss as if the transferred assets had been sold at fair market value. The effective date for the regulation is January 28, 1999.

A. Asset Sale Rule

Under Reg. 1.337(d)-4, a taxable corporation that transfers substantially all its assets to a tax-exempt organization must recognize gain or loss at the time of the transaction. The corporate tax is imposed on the taxable corporation. The act of transferring is referred to as the Asset Sale Rule under Reg. 1.337(d)-4(a)(1). It is very important to understand that transferring assets includes liquidating the corporation's assets, which was previously a taxable event to the taxable corporation, as well as transferring the taxable corporation's stock, which is considered an asset under IRC 1.337(d)-4. Thus, the corporate tax is borne while the taxable corporation's stock is owned by the selling physician/stockholders, which ultimately reduces their available proceeds. Accordingly, in an arm's-length, fair market purchase, the exempt organization would be paying fair market value if it paid at or below the values reflected in an appraisal. There would be no private benefit to the selling physician.

B. Change in Status Rule

Under Reg. 1.337(d)-4, if a taxable corporation converts to a tax-exempt organization the taxable corporation must pay the corporate taxes. The act of conversion is referred to as the Change in Status Rule under Reg. 1.337(d)-4(a)(2). Thus, the corporate level tax is borne while the taxable corporation's stock is owned by the selling physician/stockholders, which ultimately reduces their available proceeds. Accordingly, in an arm's-length, fair market purchase, the exempt organization would be paying fair market value if it paid at or below the values reflected in an appraised. There would be no substantial private benefit to the selling physician.

C. Examples of Reg. 1.337(d)-4 which Correct Previous Circumvention of Recognition of Corporate Gain

The following examples illustrate how Reg. 1.337(d)-4 requires recognition of gain or loss when a taxable corporation transfers all or substantially all its assets to an exempt organization, or converts to a tax-exempt organization.

(1) A taxable professional medical corporation, C, merges with a tax-exempt affiliate of hospital A or medical foundation B, created by A to operate C. After January 28, 1999, this "A" reorganization is subject to gain or loss recognition by C, and payment of corporate tax on gain by C.

(2) In the 1980's, hospital A formed a taxable subsidiary D, an out-patient clinic, to conduct activities that would have generated unrelated business income if A conducted them directly. D’s activities evolved so that by the early 1990’s it engaged exclusively in activities related to IRC 501(c)(3) purposes. In June 1999 D, pursuant to a plan developed in February 1999, amended its articles of incorporation to meet IRC 501(c)(3) requirements, exchanged its stock interest for a membership interest by reincorporating in another state to change from a stock to membership corporation, and successfully applied for recognition of exemption under IRC 501(c)(3). Exemption was recognized retroactive to the date D was reincorporated. Under Reg. 1.337(d)-4, D would be required to recognize gain or loss as of the date it reincorporated. (Note: under these facts the recognition event is probably an asset transfer, as the reincorporation would probably be interpreted to create a new organization. The result under Reg. 1.337(d)-4 would be the same, however, if the change was made under a state’s laws that allow a corporation to convert from fro-profit to non-profit merely by amending its articles of incorporation.)

D. Exceptions to Reg. 1.337(d)-4

Reg. 1.337(d)-4 provides exceptions to the general requirement that gain or loss be recognized, which are illustrated by the following examples.

(1) Corporation D is created in June 1999 as a for-profit ambulatory surgery center. All D’s stock is owned by A, a non-profit hospital recognized exempt under IRC 501(c)(3). In June 2001, D amends its articles of incorporation to convert to a non-profit membership organization, limit its purposes to those allowable under IRC 501(c)(3), and limit distribution of its assets on dissolution to health care organizations that are recognized

exempt under IRC 501(c)(3). D applies for recognition under IRC 508(a) in time to be recognized exempt as of the date it amended its articles. D's conversion from taxable to tax-exempt entity does not require it to recognize gain or loss on its assets because D became exempt within three years of its formation.

(2) The Service revokes Corporation F's exempt status under IRC 501(c)(3) after an examination discloses that it operates primarily for the private benefit of a group of individuals who are not members of a charitable class. F timely files a declaratory judgment petition under IRC 7428 in the Tax Court. The Tax Court upholds the revocation in a decision issued three years and two months after the Service's final revocation letter was issued. F appealed the Tax Court's decision to the Court of Appeals, which, two years later issues a decision upholding the Tax Court. Three months after the Court of Appeals' decision, F revamps its activities to eliminate the element of private benefit and reapplies for recognition under IRC 501(c)(3). F filed income tax returns on Form 1120 for the years before it amended its activities. The Service recognizes F exempt as of the date it amended its activities and implemented procedures to prevent the non-exempt activities from recurring. F is not required to recognize gain or loss as of the date it again became tax-exempt within three years of the final court decision upholding revocation. (Note that the three years run from the final decision upholding revocation, not the date of revocation.)

(3) In the 1980's, hospital A formed a taxable subsidiary, D, to conduct outpatient clinic activities that would have generated unrelated business income if A conducted them directly. By June 1999, however, only an insubstantial part of D's activities are those that would be unrelated for an organization exempt under IRC 501(c)(3). If D amends its articles of incorporation, exchanging its stock interest for a membership interest, and successfully applies for recognition of exemption under IRC 501(c)(3), it would generally be required to recognize gain or loss on its assets. However, D is not required, at the time of conversion, to recognize gain or loss on assets that are used immediately after the conversion in activities that generate unrelated business income. D would recognize gain or loss on those assets when they are no longer used in activities that generate unrelated business income. Reg. 1.337(d)-4(b)(1) provides an exception for assets an exempt organization uses in an unrelated trade or business.

## E. <u>Exception to the Exception...An Abuse</u>

The following illustrates an example of an abusive situation that negates an exception to Reg. 337(d)-4.

Medical practice G, an IRC 501(c)(3) tax-exempt professional corporation, loses its exemption in 1999. G immediately acquires all or substantially all of the assets of medical practice H for $10 million dollars with the principal purpose of avoiding the corporate gain recognition rules. In 2000 G regains section 501(c)(3) status. In this situation, the exception for an organization that regains tax-exempt status within three years of revocation would not apply.

5. Other Applications of Reg. 1.337(d)-4

A. Asset Sale Rule

The regulations exclude a transaction from the Asset Sale Rule to the extent it qualifies for nonrecognition of gain or loss as a like-kind exchange described in IRC 1031 or an involuntary conversion described in IRC 1033. For example, the Asset Sale Rule does not apply to a taxable corporation that transfers assets to a tax-exempt entity in a like-kind exchange. The reason for this exception is that the built-in appreciation in the replacement property is preserved in the transferred asset and remains in the hands of the taxable corporation. Thus, the transaction does not circumvent the corporate tax.

B. Homeowners Associations and Political Organizations

IRC 528 homeowners associations and IRC 527 political organizations are not subject to Reg. 337(d)-4. IRC 528 homeowners associations and political organizations are removed from the list of tax-exempt organization subject to the regulations because they are subject to tax on all their income except for exempt function income. Accordingly, gains from the sale of property by homeowners associations and political organizations are taxable. Thus, there is no circumvention of corporate level tax.

C. Change in Status Rule

In response to comments made during consideration of the proposed regulations, IRC 501(c)(12) mutual or cooperative electric companies, IRC 501(c)(7) social clubs, and IRC 501(c)(15) insurance companies may under certain circumstances not be subject to Reg. 1.337(d)-4.

(1) IRC 501(c)(12) Organizations

The Change in Status Rule does not apply to an IRC 501(c)(12) organization that loses its exempt status solely because it failed the 85 percent test and later regains its exempt status. However, the IRC 501(c)(12) organization must meet all the requirements for exemption under IRC 501(c)(12), except the 85 percent test, in each intervening tax year.

(2) IRC 501(c)(7) Organizations

The Change in Status Rule is modified for newly formed social clubs if they become tax-exempt within seven years of their formation, rather than within the three-year period provided for other tax-exempt entities.

(3) IRC 501(c)(15) Organizations

The Change in Status rule does not apply if a taxable property and casualty insurance company becomes an organization described in IRC 501(c)(15), and during the year it first qualifies under IRC 501(c)(15) and all subsequent years in which it is tax exempt, it is the subject of a court supervised rehabilitation, conservation, liquidation, or similar state proceeding. However, the Change in Status Rule continues to apply to all other insurance companies described in IRC 501(c)(15).

D. Unrelated Business Taxable Income Rule

Reg. 1.337(d)-4(a)(4)(b) provides that if an asset will be used partly or wholly in an exempt entity's IRC 511(a) activity, the taxable corporation will recognize an amount of gain or loss that bears the same ratio to the asset's built in gain or loss as 100 percent reduced by the percentage of use in the IRC 511(a) activity bears to 100 percent. The regulations also allow continuing deferral to the extent the exempt entity disposes of its assets in a transaction that qualifies for nonrecognition of gain or loss under IRC 1031 or 1033, but only to the extent that the replacement asset is used in an IRC 511(a) activity.

6. Conclusion

Examination and determination specialists should pay special attention to purchases of taxable corporation stock by exempt organizations. Abusive situations have been noted in stock transactions involving health care organizations, nursing homes, schools, and cemetery companies. In such a situation, a review of all documentation, including appraisals, correspondence between or among the parties, and minutes of committee or board meetings should be studied to determine if the exempt organization paid more than fair market value.